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Committee on Financial Services
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Chairman Oxley, Congressman LaFalce, Chairman Baker, Congressman Kanjorski, Members of the Committee.

Andersen and this Committee share common goals – to get to the truth about what happened at Enron and to help develop policies that will improve our capital markets, enhance audit quality and better protect the investing public. That is why I am here today – my second time before this Committee in less than two months.

We continue to learn a great deal since my last appearance before this Committee seven weeks ago. We are continuing our investigation of the Enron matter and, as I have made clear, we will take all appropriate actions.

We have a better sense of the tragic effects that the collapse of Enron has had on the company's employees and investors. We have a better understanding of the strategic business decisions that led to the failure. We have heard a good deal about failures in corporate governance on a number of levels.

And we have learned more about the relevant accounting issues. I will address some of those today.

Equally important, we have had an opportunity to reflect on the kinds of steps that might be taken – at Andersen and elsewhere – to strengthen and safeguard investors, our capital markets, and our economy.

At the outset, let me make one important observation. While no one yet has all the facts, it is clear that something very tragic and disturbing happened at Enron. Thousands of people have lost the savings they built up over years of hard work. Many people have lost their jobs. All involved with Enron must face up to what happened and take appropriate responsibility.

Andersen has done exactly that. But there is another story to be told. A story of Andersen's 85,000 employees in 84 countries around the world; 28,000 of them in the United States. The vast majority of them had nothing to do with Enron. These talented and dedicated people serve clients every day, offering the highest quality work, delivered with integrity, objectivity and skill. They know it; our clients know it. And that

dedication, that quality, and that integrity will continue to be our core values for years to come.

Having said that, I do not mean to, and I could never, minimize the profound effect that Enron's collapse has had on our firm. Legitimate and important questions about what happened have been raised by the public, by our clients, by bodies like this Committee – and, not least, by Andersen's own partners and employees. We must answer those questions when we have the facts. We've tried to do that over the past two months, and I will continue to try here today.

The Enron experience has been painful – but instructive in many ways. We at Andersen have been forced to look inward, to rethink how we do our jobs as auditors and what our jobs ought to be. We have been brutally honest – with ourselves, with our clients and with leading policymakers. We have asked the hard questions about what happened at Enron, and about the roles and responsibilities of all involved. The true test of leadership is to ask the toughest questions, follow the answers to wherever they lead, acknowledge where judgments have erred and – armed with that knowledge – build a better future.

When I last appeared before this Committee, I did more than address specific Enron accounting issues. I also pledged that Andersen would face up to its responsibilities, get to the bottom of what happened at Enron, and think honestly about the changes that must be made within our firm to reaffirm the public's confidence in our integrity. Let me tell you how we are living up to the pledge.

Setting the Stage for Fundamental Changes in Andersen's Audit Practice

At the outset, I can tell you about the steps Andersen has taken, and will take, to restore the public's trust as we move forward.

First, as we announced two days ago, former Federal Reserve Board Chairman Paul A. Volcker has agreed to chair an Independent Oversight Board (IOB) to work with Arthur Andersen LLP to evaluate the need for fundamental changes in our audit practice. We are pleased that Mr. Volcker has agreed to help us, without remuneration, in this effort. As the committee well knows, Paul Volcker is one of the most independent and innovative thinkers in American finance. Andersen, our clients and America's investors will jointly benefit from his active participation and leadership.

The Independent Oversight Board will be provided with a professional staff and assured free access to all information relevant to a full review of the policies and procedures of our firm. To assure the quality and credibility of the firm's auditing process, the IOB will have full authority to mandate changes in such practices, as it may find necessary and desirable.

As Mr. Volcker said the other day, the IOB and the Andersen partners "will together reaffirm Andersen's commitment to quality auditing."

Second, to address concerns about potential conflicts of interest, Andersen will no longer accept assignments from publicly traded US audit clients for the design and implementation of financial information systems. The firm will, of course, fulfill existing commitments.

Third, Andersen will no longer accept engagements to provide internal audit outsourcing to publicly traded US audit clients. The firm will fulfill existing commitments or, if clients prefer, immediately enter discussions to develop an appropriate transition.

There may well be legislation adopted, or regulations implemented, that address these two "scope of service" issues some time later this year. We have great respect for the processes that may ensue and the public policymakers who will lead them. But Andersen has chosen not to wait. A crisis of confidence such as that existing today demands immediate action.

Eighteen months ago, as I am sure you know, Andersen opposed a proposed SEC rule that would have prohibited providing the non-audit services I mentioned earlier to audit clients. Will some be cynical about this change in position? Surely they will. But that should not stop us. Today is a new day. Our profession – and Andersen – is living in a new environment that is dramatically different. Public confidence has eroded and one of the main issues that has contributed to this erosion is perception about potential auditor conflicts of interest. Because restoring and maintaining the public's confidence in our integrity is essential, we have determined to take this step.

Fourth, Andersen will work with the management and audit committee of each publicly traded US audit client to establish a formal process for determining the company's acceptable scope and level of fees for those non-audit services that we continue to provide.

Fifth, Andersen will establish a new Office of Audit Quality comprised of senior specialists with the sole mission of driving audit quality. This new office will be responsible for developing expertise, guidance, and review programs to assure quality, completeness, and transparency of financial statements audited by Arthur Andersen LLP.

Sixth, Andersen will create a new independent Office of Ethics and Compliance to investigate, on a confidential basis, any concerns of Arthur Andersen partners, employees or individuals from outside the firm relating to issues of audit or auditor quality, integrity, independence and compliance.

Seventh, Andersen will report to audit committees more comprehensively than currently required and include quality of results, industry comparisons and performance indicators.

These changes are being implemented alongside regulatory changes affecting the profession as a whole that I will mention later.

I told this committee in December that restoring the public's trust was our top priority. The actions we have announced thus far are first steps toward fulfilling that mission. Andersen's initiatives – the creation of an independent board that will report publicly on the firm's performance, voluntary restrictions on the scope of our practice, and other measures I have discussed – are dramatic and unprecedented for a U.S. professional services firm. They are part of a broad re-examination of our firm and our profession. The overriding purpose of these measures – and those that will follow – will be to provide assurance to clients and the investing public that changes to be implemented achieve one essential objective: quality auditing.

The Accounting and Auditing Dilemma

Andersen's reforms, however, are not the end of the matter – within our firm and beyond. The changes we have announced are meaningful, significant and helpful. But with the accounting profession in crisis, we all need to do something more fundamental. We cannot do it alone. All of us have to work together to accomplish these changes. We must transform both the ways in which auditors conduct and report audits, which is addressed in GAAS (Generally Accepted Auditing Standards), and the ways in which companies report their financial results, which is addressed in GAAP (Generally Accepted Accounting Principles).

Many participants in the system have lots of crucial information about companies; that information tells us a lot about a company's likely future performance. Management and boards must have this information to effectively discharge their responsibilities. We auditors have certain of that information. So do the analysts and credit rating agencies. So do investment banks and other financial institutions. But this crucial information is simply not communicated to the public.

Our basic problem is this: The current reporting system fails to communicate essential information about the real risks facing companies to the people – investors – who need it most. The result is that we have a system in which auditors – and the others I have mentioned – have what must be considered a very inefficient and ineffective conversation with boards, with management, and with shareholders. Figuring out how to change that is our current and pressing challenge.

Unless we make that basic change, the simple reality is that, even if all audit firms adopted reforms like the ones I've described today, there still would be allegations –

sometimes accurate allegations – that accounting treatments were misleading and that investors had been left in the dark.

In fact, I'll go further than that: such allegations would not disappear even if *every* audit conducted by *every* accounting firm was technically perfect.

How can that be? The answer is that the fundamental problem facing the accounting profession today lies in the role of the auditor and the nature of the service that auditors offer. We are asked to make sure that companies comply with the accounting rules – Generally Accepted Accounting Principles – and we as a profession generally do a very good job at that. But as Floyd Norris correctly noted in *The New York Times* last week, "[e]very accountant knows that there is good GAAP and bad GAAP. For many transactions, companies have a choice of accounting methods that can change the numbers that are reported." It is *not* the auditor who makes that choice: it is the company's management. And as every accountant also knows, some companies do the bare minimum to meet GAAP requirements, while others are much more prudent in their accounting decisions and disclosures.

Yet, the public sees only pass-fail grades. Those that satisfy GAAP get a pass. Those that don't, fail. We have a system that allows – indeed, requires – auditors to give the "same grade to every company that barely meets accounting standards," quoting the *Times* again. A noted accounting expert, Baruch Lev, made the same point recently in *The Wall Street Journal*: under existing rules and practice, all of our audit opinions are "uniformly bland."

What can an auditor do when financial statements prepared by management barely pass the current test – when they comply with GAAP but push the edge of the accounting envelope when they disclose required information but not other information that would be meaningful for investors? The auditor can go to the company's board through its audit committee. In fact, we do that often. But that does not always solve the problem. The fact remains that we cannot put in our audit opinion what we have informed the board about accounting risks and the quality of the accounting principles management has selected.

What else can the auditor do when a client only squeaks by? Our only other option is to resign the engagement. Yet that is not a practical answer. Resigning an engagement may destroy a company that is fundamentally sound. At a minimum, the share price almost certainly will plummet. And for its troubles, the auditor may also be sued. This is not, to put it charitably, an appealing prospect, and it certainly does nothing to protect shareholder interests.

So those are our choices when faced with a client whose accounting treatments are risky: give it a pass or give it the death penalty.

This situation is very frustrating for auditors. We rate all of our clients for risk and assign them a rating, from the riskiest to least risky quartile. It therefore was surprising to us when, like Capt. Renault in *Casablanca*, many people expressed shock that Andersen memoranda struggled with difficult accounting issues or labeled certain Enron practices "intelligent gambling." It is standard and essential practice for auditors to engage in just such frank analyses of risks related to a company's business transactions. The difficulty is that, if GAAP is satisfied, there is nothing that we can do publicly with that information.

This system is bad for everyone. It is bad for investors most of all. They do not get all of the information they need, or would like, to make informed decisions. Indeed, there is a significant danger that they may be led astray by our "pass-fail" report. If investors do not adjust financial statements for risk – or, worse yet, if they believe that our audit opinions vouch for the soundness of the company's business practices – they may be misled. But if investors discount *all* financial statements because they simply can't tell whether the company's accounting deserved more than a passing grade, companies that employ "best of breed" accounting practices resulting in high quality financial reporting get no benefit for acting responsibly.

The system also is bad for auditors, although perhaps not for the reasons you would expect. I am concerned that the current role we assign auditors is damaging the health and future vitality of the profession. We are not asked to be on the cutting edge of business. We are told to produce a standard report that effectively discourages differentiation among audit firms. And for this, we are faced with the virtual certainty of being sued whenever one of our audit clients fails. It is no wonder that auditing firms are finding it increasingly difficult to recruit the most talented individuals at business schools and universities. If we are to revitalize the profession, attracting the best and most innovative young people, we must ask them to produce a more useful and intellectually challenging report.

Of course, it is true that GAAP today is hardly perfect. As I testified in December, the rules governing SPE accounting must be changed to adopt a risk and reward approach. Other changes in current GAAP rules are also required.

But simply changing GAAP is not an answer to all of these problems. Accounting rules could try to present a comprehensive, accurate, and realistic historical picture of where the company has been. Or they could – more usefully, in my opinion – describe trends and paint a picture of where the company is going. But the GAAP rules are now betwixt and between: they don't do either of these jobs well. So GAAP doesn't put investors either at the baseline or at the net; it leaves them scrambling somewhere in the middle.

Tweaking, or even a wholesale rewriting, of GAAP would not cure this problem. It would not end risky accounting choices and it would not make audit opinions more informative. For one thing, many issues that arise under GAAP often have no precise answer; they require the exercise of judgment. In any event, a fundamental change in GAAP that is designed to squeeze all risk out of financial statements would result in rules that are vastly more complex and Byzantine than the already confusing ones that exist now. And new business practices would be sure to arise that would quickly make such changes obsolete. The simple fact is that GAAP in anything like its current form does not provide investors the kind of nuanced disclosure they need in the current economy.

It seems to me that we must do something more basic. To begin with, we should take a fresh look at the structure of the accounting rules, and at how auditors communicate the work they perform and the conclusions they reach.

I wouldn't purport to offer a complete answer to this set of problems here today, nor would I purport to have all the answers. And you will undoubtedly hear from others about whether any or all of the ideas that I will set out make sense. Not all of my partners, nor my colleagues within the profession, would necessarily agree with all of them. But I can say one thing with certainty: our system of financial disclosure – and thus, ultimately, the integrity of our markets – will face increasing stress until we start to look at these sorts of basic changes.

Modernize the Auditors' Communications With the Public

Let me start the dialog with these thoughts. We might consider expanding auditors' reports in several different ways.

We could deal with the content of the auditor's report, which today in almost all situations is a standard, three paragraph letter that provides no real insight to the investors. What investors need to make informed decisions is information allowing them to understand the *future* prospects of the company. That information is not provided today either in the financial statements or the auditor's report. Later, I will deal with the financial reporting reforms, but now let's deal with possible reforms to what the auditor can report. Investors need information about the risks and quality of the financial reporting.

I would suggest that we replace the current "pass/fail" system with an auditor's report that grades the quality of the company's accounting practices. As discussed above, this change will give investors important guidance in how to assess the company's financial statements, the information contained in those statements and related financial risk.

Modernize the Financial Reporting Model on a System-Wide Basis

But if we truly are to get at the information deficit that now plagues investors, we cannot stop with a consideration of audit opinions. We need to address this question: what is the purpose of the financial reporting model? Enron's collapse, like the dot-com meltdown, also is a reminder that our financial reporting model – with its emphasis on historical information and a single earnings-per-share number – is out of date and unresponsive to today's new business models, complex financial structures, the speed with which information is disseminated, and associated business risks.

As tragic and unnerving as the collapse of Enron is, we can help America's investors if we use this as an opportunity for systemic reform. We need to move to a more dynamic and richer financial reporting model. We need to provide several streams of relevant information.

For example, companies could disclose more about the imprecision of certain amounts in financial statements. As you know, financial statements list the types of assets and liabilities that a company owns and owes. Accountants can measure some of those assets and liabilities with great precision. One example is the amount of cash the company has in the bank. Other measurements, however, are inherently imprecise, such as the estimated value of a complex and long-term financial instrument that is not market traded.

Companies could help investors by disclosing the range of values for those assets or liabilities that are imprecisely measured. For example, consider a complex financial instrument that is settled 10 years in the future, and that is reported in financial statements at its fair value. As is often the case with these instruments, there is no deep and liquid market that provides daily evidence of the instrument's value. Rather, accountants must estimate the value using sophisticated models that provide an estimate of the instrument's value. In that case, the company could disclose the range of possible values and the key assumptions in the valuation model that drive those values.

Helping investors understand which assets and liabilities are imprecisely measured and the amount of that imprecision could help investors better assess a company's risks and opportunities. It could also relieve some of the pressure related to meeting earnings per share targets to the penny.

A second opportunity for companies to improve financial reporting is to disclose more information about the effects of unusual transactions and events. In too many cases, because of insufficient disclosure, the effects of unique transactions or events obscure key trends – and the quality of investor's analysis suffers as a result.

Here's a simple example. Let's assume that a company's core ongoing business is stable but not growing. However, in the current year, the company has entered into certain non-recurring transactions that have temporarily improved sales and profits. Without disclosure about those one-time transactions, investors could get a misleadingly rosy picture about the company's growth prospects and real trends.

Financial reporting needs to better distinguish between the financial effects of a company's core, recurring, and sustainable activities on the one hand, and peripheral, non-recurring or unsustainable activities on the other. We understand that the FASB has this topic on its agenda and we recommend that the Board give it a top priority.

A third area for change relates to so called segment reporting. For investors analyzing a company involved in diverse businesses, information about business segments is as important as information about the company as a whole. Segment reporting is a proven tool to identify and analyze opportunities and risks that diverse companies face. Further, for a diverse company, investors may find it more effective to project earnings or cash flows on a segment-by-segment basis than on the basis of the company as a whole. Segment data thus provides for a more refined valuation than otherwise would be possible. Accordingly, why not report on more business segments and provide more information on each, including MD&A information by segment? I should note that this issue is controversial, because some companies believe that revealing this information would compromise sensitive and confidential information.

Along these same lines, we need to expand the number of key performance indicators, beyond earnings per share, to present the information investors really need to understand a company's business model, business risks, financial structure, and operating performance. Doing so would reduce the near mythical status that earnings per share now holds and provide investors better and more informative data. Would investors be so focused on whether EPS is off by a penny if they were told outright that analysts' estimates of earnings per share covered a wide range and the financial statements contained "stress-testing" of the company's EPS by demonstrating the effect of varying key estimates of assumptions? If we reduced this myopic focus on EPS, wouldn't management be less pressured to hit the mark? And wouldn't management bring less pressure to bear on audit committees and auditors to accept borderline accounting?

In addition, investors need to identify *trends* in reported information, which is key to valuing companies and understanding risks. Unfortunately, today's reporting model does not give investors enough information on this. In too many cases, the effects of unique transactions or events obscure key trends, and the quality of investors' analyses and insight suffers as a result. Financial reporting needs to better distinguish between the financial effects of a company's core recurring and sustainable activities on the one hand, and peripheral, non-recurring, or unsustainable activities on the other.

We could also insist on "plain English" financial statements. In 1998, the SEC introduced the concept of plain English sections of some SEC filings. Why? To help investors understand the disclosures required by securities laws and make more informed investment decisions. The SEC's rules on plain English, however, do not apply to financial statements. If we want investors to make informed decisions, we have to give them financial statements and notes that are free of jargon and vague, boilerplate explanations.

Strengthen the Role of Audit Committees and Assuring the Integrity of Audit Information

A number of suggestions have been made in recent years regarding audit committees, and progress has been made in this area. At the same time, I would urge consideration of a number of ideas that will further engage committee members in ensuring the integrity of accounting decisions. The audit committee is the representative of the shareholders. They should engage management and the auditor to ensure that risk is managed, and it must ensure that crucial information – whether it originates with management, the auditor, a credit rating agency, or any other source – is communicated to the shareholders in an intelligible way.

Insure that Auditors Get Full and Accurate Information

We should give serious thought to strengthening the penalties for misleading auditors – specifically, making it a felony to lie, mislead or withhold information from the auditor. I want to be clear on this. The overwhelming majority of corporate managements make good-faith, diligent efforts to provide their auditors with all information relevant to the audit. But that cooperative attitude, unfortunately, is not universal. And audits are only as good as the information on which they are based. As we all have learned painfully from the Enron experience, a company's failure to disclose important material to its auditor may have catastrophic consequences. I urge the committee to look seriously at this issue.

Reform the Accounting Profession's Regulatory Model

We also must reform our patchwork regulatory model. An range of institutions – from the AICPA (American Institute of Certified Public Accountants) to the SEC and the ASB (Auditing Standards Board), EITF (Emerging Issues Task Force), the FASB (Financial Accounting Standards Board), state regulatory boards – all have important roles in the accounting profession's regulatory framework. They are all made up of smart, diligent, well-intentioned people. But the system simply is not keeping up with the problems raised by today's complex financial issues.

So far as accounting standards are concerned, standard-setting is too slow. The FASB has great technical expertise. But its processes are impossibly cumbersome in an economic environment that is as changeable and fast-moving as ours. It can take years for FASB to react even to the most pressing issues. Enron should teach us that this simply is not acceptable.

At the same time, responsibility for administering discipline is too diffuse and slow, and punishment is not sufficiently certain to promote confidence in the profession. Too many institutions – the SEC, the AICPA, 51 state accountancy boards – now have a role. This gives us the worst of both worlds. On the one hand, having so many regulators and confusing lines of responsibility means that some things warranting regulatory attention may fall through the cracks altogether; we welcome a firm hand to enforce standards, but an effective system must have certainty, uniformity, and consistency. On the other hand, having multiple regulators places auditors at risk of double, triple, or quadruple jeopardy. A healthy debate on some of these issues has begun with the SEC's recent proposal to create a Public Accountability Board.

Improve Accountability Across our Capital Markets System

The fact is that we need to consider the responsibilities and accountability of all players in the system as we review what happened at Enron and the broader issues it raises. Millions of individuals now depend in large measure on the integrity and stability of our capital markets for personal wealth and security.

Of course, investors look to management, directors, the company's professional advisers, and auditors – as well they should. But they also count on investment bankers to structure financial deals in the best interest of the company and its shareholders. Investors trust analysts who recommend stocks, and fund managers who buy stock for investors, to do their homework – and to walk away from companies they don't understand. They count on bankers and credit agencies to dig deep and act responsibly. For our system to work in today's complex economy, these checks and balances must function properly.

A different and more robust reporting system might have shed earlier light on the fundamental business failures that caused Enron to collapse. As the Committee knows, Enron leadership turned to the use of special purpose entities ("SPEs") as the company changed the focus of its operations from its core energy trading business to volatile and untested markets, such as broadband and water, as well as a variety of overseas assets. Financing these risky new lines of business required very substantial amounts of capital; to raise the necessary funds, Enron made increasing use of structured finance vehicles, including SPEs. One of the primary assets supporting the off-balance sheet debt of these entities was unissued Enron stock. This approach may have seemed like a good idea to the company when Enron stock was trading at $90 per share and the company predicted

that it would go to $150 per share. Leading financial institutions competed to provide Enron with funds.

As we all now know, however, these new and exotic businesses ultimately proved unsuccessful. The investments made by Enron were themselves unprofitable. Compounding the problem, the SPE deals negotiated by Enron management contained contingencies that exposed the company to liabilities should the Enron stock price fall or its credit rating decline. This overall decline in the stock market, coupled with Enron's lackluster business performance, led the company's share price to decline by approximately 65 percent between January and October 2001, *before* the earnings restatement and the cascade of bad news that preceded the declaration of bankruptcy. A liquidity crisis ensued when the share price collapse caused a downgrade in Enron's credit rating, which resulted in the company's off-balance sheet debt becoming current. Investors lost confidence as it became clear that the company had too much debt supported by too few assets; creditors insisted on a greater share of assets pledged; trading counterparties refused to deal with the company. This loss of confidence created a "run on the bank" that made it impossible for the business to survive. Enron's performance thus mirrored that of the other Internet companies that, in many ways, it closely resembled.

In this regard, you might have thought that the function of disclosing risk was performed by the credit rating agencies. In fact, as many have noted in connection with Enron's collapse, the agencies had complete, unfettered access to Enron's financial data, and their actions played a significant role in the company's ultimate failure. Their sophisticated analysts reviewed proprietary information to which ordinary investors had no access. The agencies were charged with using this information to assess company risk. Yet the agencies are under no mandate to, *and do not*, disclose the analysis that underlies their ratings decisions. As we consider how to make auditors' reports more informative, we might think about the rating agencies' role as well.

Report of Enron's Special Investigative Committee

Some of the questionable decisions that led Enron into this debacle are touched on by the report issued on February 2 by the Special Investigative Committee established by Enron's Board of Directors.

This document is over 200 pages long and took more than three months to produce. I have not yet had a chance to study the document carefully myself. However, we have experts within the firm who have been assigned the task of analyzing and investigating the allegations in the report. They are doing that now.

The report acknowledges the restrictions on time and resources that limited the scope of the Special Investigative Committee's review. Furthermore, the report notes the lack of

access to people and documents that the Committee admits may have information relevant to the report's conclusions.

The Committee did *not* speak to people at Andersen. Although the report suggests that we did not cooperate with the investigation, nothing could be further from the truth. We believe that our record of cooperation with the numerous investigations into the Enron collapse – and, I hope, my presence here today – speaks for itself. The truth is that our people made a number of attempts to communicate with the Special Investigative Committee, their investigators, and their accounting advisers. We thought that this made sense so that we could both assist the investigation and be in a position to assess the impact of any new information arising from the investigation on a timely basis. Those attempts were declined.

However, the report also cites numerous instances of possible additional secret arrangements among the company and the related-party special purpose entities. The report says that there are indications of hidden side agreements and undocumented understandings that may have altered significantly the economic substance of certain transactions between Enron and the SPEs. We need to investigate the accuracy of these alleged matters. Only then can we assess whether they affect the original accounting for these transactions.

Our investigation of these matters, and others, is ongoing. We will continue to pursue these matters and I promise to share our conclusions with the Committee at the appropriate time.

Accounting Issues Related to Chewco

Let me conclude by turning to some specific questions the Committee asked me to address.

The first of these involves an expansion and clarification of details of the testimony that I presented to the Committee on December 12.

Those details relate to my description of Enron's 1997 transaction with the special purpose entity known as Chewco. Many of us have had tutorials on SPEs in recent weeks, and have come to know that a company may avoid consolidating its financial statement with that of an SPE only if a requisite amount of independent equity capital is at risk in the SPE. Against that background, the two central points I made about Chewco in my December testimony were accurate:

- First, we at Andersen were not provided critical information about the nature of Chewco's arrangements with Barclays, the major financial institution that was

represented to us as being the source of the independent equity capital at risk in Chewco.

- Second, had we been provided that information in 1997, we would have objected to the accounting treatment used by Enron during the period 1997 through the first two quarters of 2001 for this transaction. Thus, there would not have been any need for the Chewco/JEDI portion of Enron's restatement.

My remarks should, however, be clarified in one respect. Based on documents we did not have in 1997 but that were made available to us in early November 2001, we now know that the $11.4 million "equity interest" provided by Barclays was, in fact, in the form of yield certificates the bank purchased from two intermediary entities, Big River Funding LLC and Little River Funding LLC. If these facts had been known to us in 1997, a key issue would have been the terms of the certificates. Depending on the terms, Enron could have been required to treat the capital as debt rather than equity, disqualifying the SPE from non-consolidation.

When I last appeared before this Committee I was not aware of the details of these intermediary relationships. In fact, Little River Funding LLC held interests in Big River Funding LLC. Big River Funding LLC, in turn, held interests in Chewco. It was my understanding at the time of my testimony that Barclays' interest was direct. These facts, however, were not at the root of our conclusion that Enron's accounting for Chewco was in error.

The reason for that conclusion was that, under a separate agreement between JEDI and Chewco dated December 30, 1997 – which was not provided to our team in 1997 when we asked for all Enron and JEDI documents – JEDI agreed to deposit $6 million into a reserve funding account that was established for the benefit of Barclays. In my testimony on December 12, I stated that this agreement was between Enron and the bank. It appears that the deposit was in fact a condition upon funding of the Barclays certificates. The cash collateral agreement, whether from Enron or JEDI, meant that only about half of the required three percent equity was actually at risk. This alone meant that Chewco did not qualify as an unconsolidated SPE.

Because the establishment of the reserve funding account was sufficient by itself to cause Enron's accounting for Chewco and JEDI to be incorrect, we did not complete – and still have not completed – our analysis of the accounting implications of the terms of the intermediary investment vehicles or the yield certificates. We advised Enron of our conclusion immediately, and the disclosure made by Enron that it would be restating its financial statements reflect that advice.

I appreciate the opportunity today to provide this clarification, which is also reflected in a letter I sent to Chairman Oxley, at his request, on January 21, 2002. And I want to

personally thank Chairman Oxley for the fair, thoughtful, and open manner in which he handled this issue.

Recent Developments in the Markets and Boardrooms

The Committee also requested that I address whether Andersen has asked clients to disclose more details about the creation of SPEs, related party transactions, and mark-to-market accounting; and what other developments we have seen in the markets and boardrooms as a result of Enron's collapse.

We encourage our clients to enhance financial statement disclosure to ensure full transparency. For example, under circumstances where GAAP may allow a range of disclosure, we encourage disclosure that will enhance the reader's ability to fully understand the business purpose and financial impacts of the transactions involved. With respect to SPEs and related party transactions, we have reiterated the need for full and clear disclosure of structures and transactions, their financial attributes, including contingent liabilities, and other disclosures, such as related party involvement that may be relevant to users of financial statements.

We have taken substantive steps to address accounting standards related to SPEs, mark to market accounting, and related party transactions. On December 31, 2001, we joined with the other Big 5 accounting firms in sending a petition to the SEC asking the Commission to issue guidance related to improving Management's Discussion and Analysis in annual reports and on Form 10-K for 2001. Our petition, which also was endorsed by the AICPA, included a draft of an interpretive release that proposed guidance in three critical areas:

1. Liquidity and capital resources – effects of off-balance sheet arrangements and other commitments.
2. Financial position and results of operations – effects of certain energy and commodity trading activities.
3. Financial position and results of operations – effects of transactions with certain parties that are not clearly independent.

The SEC released interpretive guidance on January 22, 2002, addressing the Big 5 petition and draft guidance. We fully expect the SEC to act on this petition within the next few weeks and believe it is likely that any resulting guidance would be effective for the upcoming 10-Ks of registrants with December 31, 2001, year-ends.

Similarly, we perceive increasing concern by management and boards about the adequacy of their company's internal controls, accounting and disclosures so as to avoid Enron-type problems.

But with that said, I must add that, in my opinion, the current controversy over SPEs is a symptom of the broader problems affecting our financial disclosure system. SPEs are the issue of the day. We can change accounting rules to address them. But that will not avoid future controversies. FASB will labor for two years to reform one accounting rule; clever investment bankers, lawyers – and, yes, clever accountants – will find a way to circumvent the new rule in two days. It is literally the case that there is a cottage industry of accountants and bankers at major financial institutions who devote themselves, in effect, to reverse engineering transactions so that they technically comply with GAAP. Indeed, many of the most talented accountants find it more challenging and intellectually rewarding to engage in that sort of work than to issue the pass-fail grades that, as I have detailed, is the usual product of audit firms. I hope that will change if we chart a serious course for reform.

Conclusion

Mr. Chairman, we have an opportunity to make some good here from what is otherwise a tragedy on many levels. We should act wisely, responsibly, and boldly.

Tinkering on the edges will not be enough. If, for example, we limit ourselves to fiddling with particular GAAP rules, I fear that, in a few years, this Committee will be holding another hearing like this one – although I very much hope that I will not be the one sitting in this chair. We must go further. As discussed above, I would suggest that we replace the current "pass/fail" system with an auditor's report that grades the quality of the company's accounting practices. This change will give investors important guidance in how to assess the company's financial statements, the information contained in those statements and related financial risk.

I do not mean to be alarmist in my comments here today. I am not suggesting that the financial statements of America's leading companies are a minefield strewn with hidden booby traps. I have no doubt that our markets are the world's strongest, our system of financial reporting the world's most transparent, and our accounting profession by far the soundest.

But we can do better – much better. Our current reporting system is almost 70 years old. In that time, the world has changed; our economy has changed; my profession has changed. The system must change, too.

I will, however, offer you a guarantee of one thing that will *not* change. When he founded his firm almost 90 years ago, Arthur Andersen promised that it would "think straight and talk straight." The 85,000 dedicated professionals who now work at that firm strive to fulfill this pledge every day. We are determined to convert our current challenge into an opportunity: we will clearly reaffirm Arthur Andersen's principles for a new century, serving our clients – and the public that relies on our work – with unflinching

candor and integrity. The steps that I have described earlier today start that process. All of us at Andersen will work with you in the weeks, months and years ahead to continue it.